DOW THEORY LETTERS INC.

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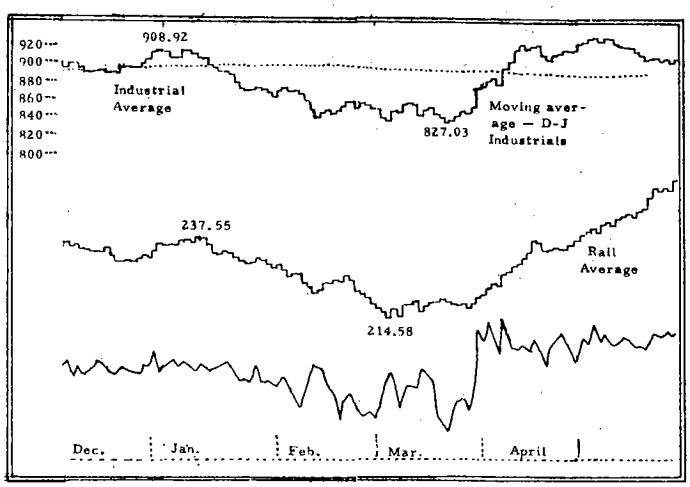
THE MARKET: For 27 months (since the 995.15 Industrial top of 1966) a primary bear market has been trying to gauge the value of thirty of the nation's leading industrial corporations (i.e., the D-J Industrials). The bear market has been trying to appraise their value against a background of inflation, monetary degeneration, and towering deficits.

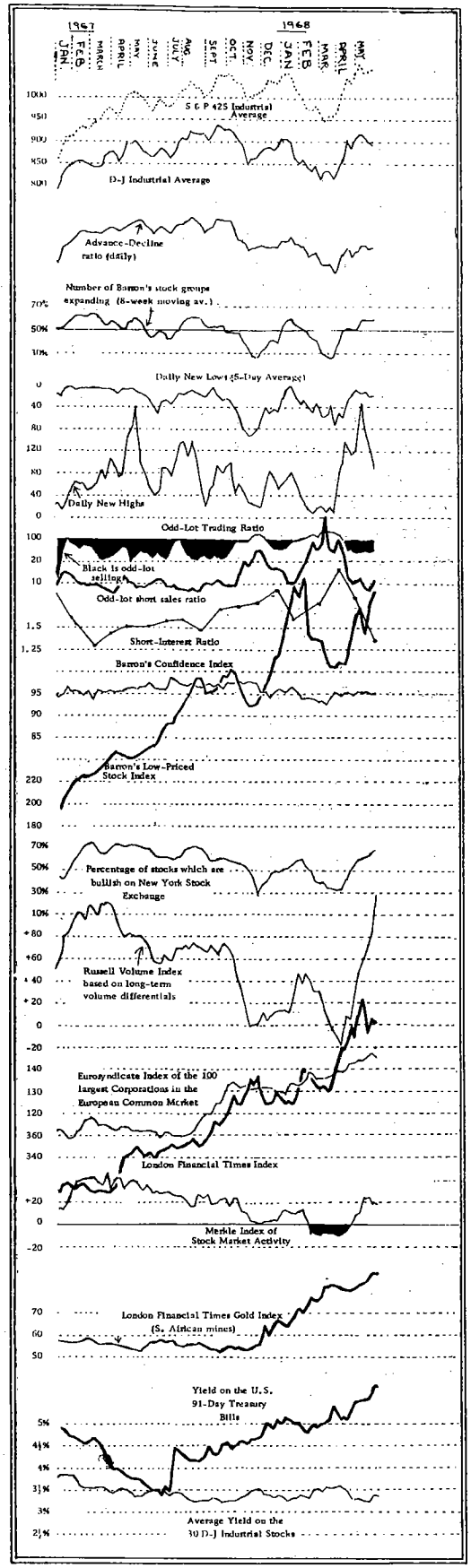
So far, the verdict is unclear. Inflation has been galloping since early 1966, the country has gone way over its head in war debt and domestic debt, and the real value (gold and silver) has disappeared from our metal and paper currencies. As of now, the Industrial Average is still roughly 100 points below its 1966 high. At the 1966 bear market low Industrials were 251 points below their 1966 high. The market is saying that no real disaster or super-crisis is in sight. The prelude to a true crisis should be a market crash. And so far, no crash has materialized.

Yet, as the great Dow Theorist Robert Rhea was fond of saying, "the market can change its mind in an hour." If my interpretation of the Dow Theory is correct, if we are indeed in a primary bear market, then each month that passes brings us one month closer to the ultimate day of reckoning.

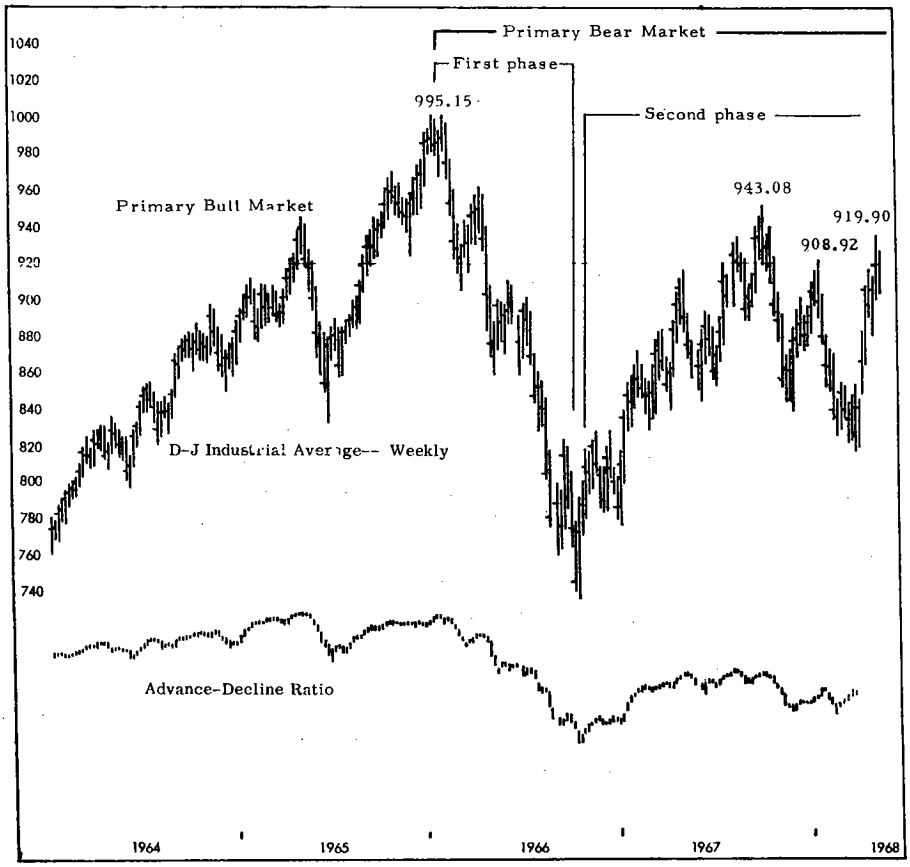
Essentially, that is the theory behind bear markets (and bull markets). During an extended bull market there will eventually come a time when the market "blows its speculative top." This thought seemed inconceivable to those of us who were bulls in 1957, 1958 and 1959. But it came to pass, and during 1961 and again during 1965 and 1966 we all saw the market "blow through the roof."

Now, it seems just as inconceivable that the current, long, drawn-out bear movement will eventually turn into a true bear market collapse. But this is exactly what I foresee in the months ahead. The day of reckoning may be postponed until election time, it may even be extended into 1969. But the time is drawing ever-closer, and it is "in the cards."




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Euroyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

As seen on the accompanying chart, the first phase of the bear market lasted from February, 1966, to October of that year, a period of eight months. The second phase of the bear market began at the October, 1966 low of 744.32. As of now the second phase is in its 27th month, which means that the second phase is already four times as long as the first phase. In my opinion, the second phase is far from over, and it will not end until the Averages break below their 1966 lows.



A study of the chart will show that this second phase has been typical in that it has been deceptive, confusing and highly complicated. Note how symmetrical the first phase of the bear market was. The first phase was composed of three distinct downward movements and two distinct upward corrections.

But the second phase lacks symmetry completely, it is hard-to-follow, it has already produced numerous "foolers." The first fooler was the powerful rush up from the 1966 lows. To all appearances, a new bull market had started from the 744.32 low of 1966 and nothing would stop it until the old highs were bettered. But the initial rise topped out at 943.08 in September, 1967, and a series of two sharp declines ensued. Following the extreme bullishness of 1967, everyone turned dead bearish at 1968 lows.

Then came the most recent rally, based on Mr. Johnson's "abdication," and based on Vietnam negotiations and a passage of the 10% surtax bill. Again, bullishness was rampant on Wall Street, and speculation flared. Now we find the market consolidating (if you are bullish) or building a top (if you are bearish), and in terms of Dow Theory all this means is that the second phase of the bear market continues to drag on.

Those of us who were in the market during the second phase of the 1949-1966 bull market remember the period from 1953 to 1957. That was the second phase of the great bull market, and it contained every conceivable type of deceptive action, shocking news event, false signal and emotional whipsaw. The gloom brought on by the 1957 decline was so thick you could cut it with a knife, and almost everyone was convinced that the bull market had breathed its last. All the market indicators had turned bearish, and Wall Street literally took pride in its stony bearishness. But by late-1958 the Averages were at the highs as the primary bull trend reasserted its irresistable force. All in all, the 1953-57 second phase of the bull market could not have been more difficult and deceptive.

I feel that the current second phase of the primary bear market is shaping up as an equally deceptive period. Each important advance generated new hopes for the bulls, each sharp decline sparks "I told you so" admonitions from the bears. The pattern of the Averages has already proved highly deceptive on two important occasions, and bull and bear signals seem to serve more to confuse than to clarify the situation.

My guess would be that this kind of situation will last until near the end of the second phase of the bear market. Before it is over, this second phase will probably wear out the bulls and the bears, the speculators and the investors. That is why I continue to stress the long-term implications of the Dow Theory. Simply stated, Dow's Theory tells us that the bull tide ran out in February, 1966, and that the bear tide has now taken over. The best procedure, therefore, is to wait patiently until the bearish forces have fully expressed themselves in three market phases. We will find it generally more profitable and less nerve-wracking to avoid all trading and in-and-out speculation, while waiting for the market to tell its own story.

Ironically, while the second phase is dragging on, fund after fund is being formed, and emphasis on performance has reached a new peak. Everyone and his brother is out to beat the bear market—with the help of professional skill as characterized by the "new breed" of fund managers. The accent is on youth, guts, turn-on-a-dime decisions and big money. In time, I believe, books will be written about this era of mass "professional speculation" with public funds, and I would hazard the guess that these books will be in the form of exposures and denouncements.

* * * *

Referring to the current market, a persistent divergence has built up between the Industrial and Rail Average. Following the 919.90 peak of May 7, Industrials have trended steadily downward while Rails pushed to successive new highs. Such action, in the past, has always signalled danger at the end of a powerful upward movement. I believe the action of the Averages is saying danger now.

It is of particular interest that while Industrials have been sagging, the AMEX average has pushed to new record highs, thus underscoring the intense speculation which has characterized this market. At the same time, Barron's Low Priced Stock Index has risen to within a hair of its old high. Veteran readers remember that this same type of speculation (against a sag in the Industrial Average) occurred in early 1966, just prior to the 251 point drop. Frenzied speculation against a background of decline in the blue-chip or investment issues is always an ominous sign.

May 27 provided a particularly dramatic day with the Dow Average down 3.68, while the AMEX rallied and volume on the junior Exchange was the third heaviest on record.

COMES THE DAWN: It is slowly dawning on the world that the governments of the Anglo-Saxon nations (i.e., Britain and the United States) are indeed know-nothing governments. In the space of a dozen years the once-mighty British empire has been dismantled like a set of child's blocks. The British pound sterling, once impregnable, has become a drug on the market—with unwanted sterling balances piling up throughout Europe and Asia. Under the threat of successive dumping of pounds by worried creditors, the value of sterling last week sank to an all-time low.

The Free World now waits for the next sterling crisis which could well come this summer. There is talk of the Prime Minister resigning if another sterling crisis strikes, but already conditions have moved so far in England that a mere resignation by Britain's chief incompetent would do little good.

The London Economist (May 18) talks about the case for a "floating" pound sterling. But such an emergency measure would, in itself, be a sign of defeat. Here is what the Economist says. "What about a floating exchange rate for the pound? One difficulty is to know what this means. There has long been a respectable case for arguing that it might be easier for the Bank of England to control day-to-day speculation against sterling if the rate could move within broader limits than $2.38 to $2.42 (the current legal limit in Britain). This view has had eminent advocates in some surprising places. But a drowning man should know the difference between floating and sinking; a forced resort to a floating rate, at a moment of sterling crisis, by a battered Wilson government that had lost all credibility as a guardian of the country's affairs, would not be the sort of operation that even dainty theoreticians would ideally recommend."

Suffice it to say that only 18 months ago the Economist was a Wilson supporter. But even the Economist must eventually admit to the total failure of Mr. Wilson's policies. Actually, it is not fair to blame all of Britain's trouble on Wilson. The British people, like the Americans, have wanted to have their cake and eat it too—for a long time. The Economist sums up the problem nicely in the following sentences: "The country wants the economic ends of increasing prosperity all right, but it is adamantly reluctant to will the means. Successive governments in the 1960's have discovered that the electorate is not prepared to tolerate tough, unpopular economic measures, however necessary, for much longer than six months. The country has sought, and still seeks, a painless economic miracle to be performed with biblical speed and precision."

As discussed in the last Letter, the U.S. has now contracted a full dose of the "English disease." The story here is inflation, a degradation of U.S. currency with no backing for the dollar and little or no precious metal in our coins, deficits, "banana republic" style outpourings of currency, and a progressive decline in the buying power of the dollar. In terms of 1939 dollars, the dollar was worth 71¢ in 1946, 49¢ in 1957, 43¢ in 1965 and 40¢ in March of 1968.

This system of legalized "robbery" has made a mockery of saving, and has finally brought about a true flight from the dollar. In response, the price of anything and everything of value, paintings, stamps, property, stocks, antiques, coins, vintage autos, has soared. The cost of debt has also sky-rocketed, with interest rates currently pressing against or surpassing the historic highs of 1966 and 1967.

 Within this framework, I feel it is worthwhile repeating a few paragraphs from a speech given by my friend John McFalls before the May, 1968 meeting of the World Affairs Council.

"During the month of March, our gold reserves plunged to $10 Billion, and more than $2 Billion of this belongs to the IMF, or underwrites special loans repayable in foreign currencies. Foreigners now hold a $32 Billion mortgage on the remaining $8 Billion of gold in Fort Knox. It would be necessary for us to raise the price of gold to $140 per ounce to make good our government's promise that the dollar is still as good as gold. To cap it off, Chairman Martin has recently warned of deficits ranging well above $30 Billion. At this rate, the United Stated will be forced to increase our money supply by an additional $100 Billion within three years. This exceeds the present market value of all the gold mined during the entire history of the world!

"The battle lines are now drawn between creditor and debtor nations and, at home, between those who have profited by rising security prices and those who are up to their eyeballs in debt and now threaten our campuses and major cities with insurrection. The problems are inseparable and reflect the price we pay for nationalism in a world divided against itself.

"Inflationary and deflationary forces are delicately balanced on the razor's edge. The record of the past forty years reveals what can happen when the irresistible forces of war and social unrest encounter the immovable discipline of gold. Something has to give! "

NOTES AND QUOTES: It is becoming progressively clearer than Senator McCarthy's campaign is bogging down in political amateurism and lack of funds. At the same time, Robert Kennedy's campaign is picking up strength. Humphrey, so far, has gathered little grass-roots support, and without an all-out endorsement and supreme push from President Johnson, it is doubtful whether Mr. Humphrey is going to swing the nomination.

My current guess would be that the election is shaping up as Kennedy vs. Nixon with the probability that Kennedy will win. As far as subscribers are concerned, we should remember that Robert Kennedy is the most feared man on Wall Street. Lacking the moderation of his brother, lacking a grasp of fiscal responsibility, considering his dedication to massive spending and serving the minority interests, no single man would do more to upset international sentiment towards America's fiscal soundness.

* * * *

I believe that Hanoi wishes to keep the negotiations going, but going nowhere — until nomination time. This will serve to keep LBJ out with no chance of being drafted, and it will clarify who Hanoi will have to deal with after the elections. There is little doubt that Hanoi would prefer to deal with a man like Kennedy who is fully committed to ending the war.

A second reason for "talking-and-fighting" is that pressure is continuing to mount on the dollar, and therefore towards an almost crisis-need for the U.S. to end the war. The longer the war, the shakier the U.S.'s finances. Thus, Russia has a stake in a prolonged war (devaluation means a higher price for gold, and Russia is a leading gold producer). On the other hand, an early ending of the war would almost have to be on Communist terms, and this would mean obvious gains for Russia in her power struggle with the West. In other words, as far as Russia is concerned it's a case of "heads I win, tails you lose."

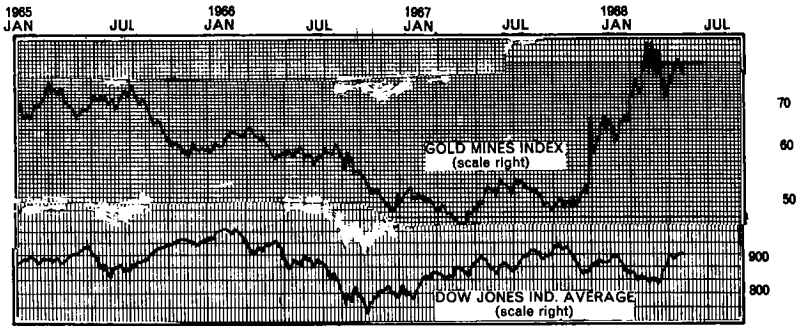
People have asked me how I think we will get out of this mess. "Who would you vote for in the 1968 elections?" I simply do not know. In the past, when this nation was threatened with grave crisis, we have always come up with an outstanding leader. But today we need a leader who is as honest as Washington, as politically adept as Franklin Roosevelt, as crusading as Wilson, as tough as Theodore Roosevelt. Where is he? I must confess I do not see him. Nixon is politically poisonous, he will not capture the hearts of the people. Rockefeller is running with the wrong party, he is basically a Democratic spender. Reagan is a very limited man as far as the international picture is concerned. Robert Kennedy is feared by business, a spender of the first order, and an ignoramus in the economic sphere. McCarthy is honest, but, like Kennedy, totally unaware of the monetary situation.

At times, history shows that a single man can shape the trend of world events. At other times, the trend of world events is so insistent and potent that men are powerless to affect or resist it. This may be one of those times when events overtake the men. In view of the force of events today, and in view of the "lightweight" character of the American candidates, I would say that we are going to see the tide create history over the year or so ahead — rather than men themselves.

I thought the little chart on page 5 (courtesy of Security Analysts Ltd., 354 Kennington Rd., London S.E. 11) was of particular interest. It shows the path of the South African Gold Mine Index and the D-J Industrial Average from January, 1965 to date.

Note that since early 1967 the Dow and the Gold Index have parted ways. Although the Dow is still below the late 1967 peak, the Gold Index has risen better than 50%. This would suggest that investors believe that from here on gold shares are going to be a better vehicle for protection than the high-grade Dow stocks. Another way of looking at it is that the investment world now views the gold shares as being considerably "cheaper" than the Dow stocks.

In time, I would expect these two averages to spread even wider apart, with the Dow going lower as the Gold Index rises. The story of coming events could well be told by the spread between these two indices.



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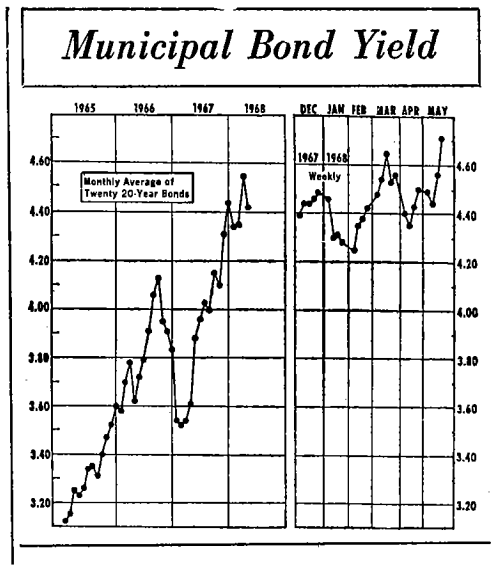
Secretary of the Treasury Fowler has been notably calm about all the goings on in the money and gold front. But suddenly he is almost hysterical. In a dramatic departure from tradition, Fowler broke last week with the President on the tax bill. Whereas LBJ wants only a $4 billion cut in expenditures, Fowler now insists on the $6 billion cut demand by Wilbur Mills. Announcing that he is a "fiscal Paul Revere," Fowler now shouts that a tax increase is needed to avoid "a full scale international financial crisis."

It strikes me as rather pathetic to see the same men who had a hand in inflating the currency and stoking the fires of inflation now joining in the chorus of "We have to do something and fast." Of course, there is always one recourse for these men. And Fowler, like so many others, is grabbing it. Mr. Fowler intends to resign sometime during fall—or sooner.

MUNICIPALS IN THE DUMPS: Last week saw the Municipal Bond yields go through the roof as many of these tax-exempt issues touched record lows. Average yield on the Index hit 4.71%, well above the 1966 or 1968 crisis highs. Furthermore, the total of new issues to hit the market is estimated to be around $1 billion within the next thirty days. This, added to the visible supply, takes the total to be sold in June to about $1.5 billion, far above the "comfortable level."



Many months ago I warned subscribers to "go easy" in the bond market, regardless of the fact that many issues appeared to be on the bargain table. "Yields are rallying," as the wags say on Wall Street, and when yields rally the price of bonds head into the cellar. In the face of this, the continuance of investment confidence is little short of phenomenal.

FLASH: On Monday, May 27, the broadly-based and widely-followed D-J 40 Bond Average broke its 1967 low of 74.62 to close at 74.55. This is the lowest closing for the 40 Bonds since 1933. I consider this a distinct danger signal for the general markets.

WHAT OTHER SERVICES ARE SAYING: The Granville Market Letter, May 24, 1968: "Seventeen months have gone by since President Johnson asked for a tax hike. Despite spiralling war costs, wage demands, rising casualties and a major gold crisis, the tax bill prospects are again receding. The long delay in enactment has accentuated the current tight money crisis and the Fed is resorting to the only effective weapon against inflation it has left to use.....the interest rate. It has not hesitated to use it and will continue to use it until the crisis has passed. Yet even now, in the face of an obvious crisis becoming increasingly acute, more members of Congress are heading back to their home states to the campaigns, increasing the difficulty of maintaining a Senate-House tax bill vote majority on hand. Time is rapidly running out!"

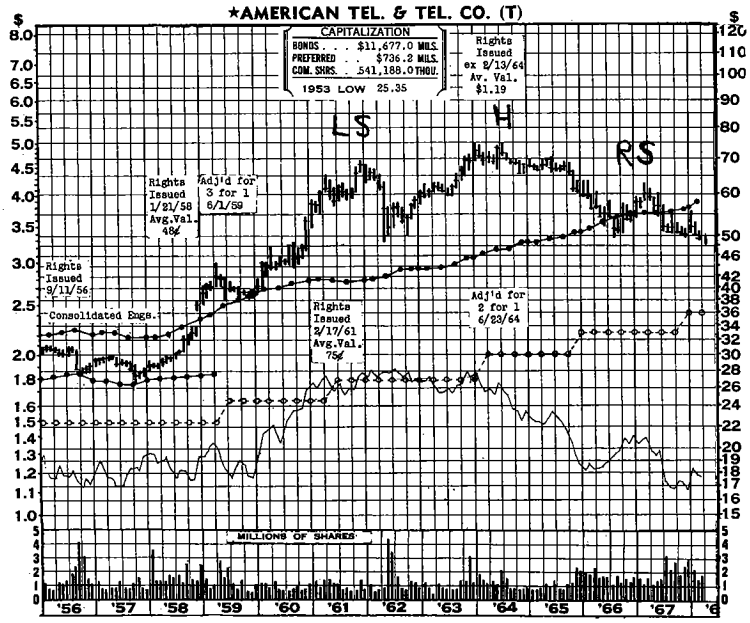
From the Harry Schultz Letter, May 20, 1968: "Can DC threaten the Deutchbank if they don't buy bonds with $ credits? Can Fowler arm twist the Italians again if they ask for more gold? Will the Bank of England or the Treasury issue true statements about short term claims or will they bend facts (legally) to present an incorrect image just to keep from paying the just due of the piper? These politicos are under pressure themselves, so they have to put pressure on others. It's a kind of kill or be killed law of the political jungle.....Am I saying nothing is predictable now? Heavens no. I'm only saying that the things we know will happen can't be placed in time with great accuracy. For example, I know gold will be increased in price. In fact it is already climbing in the free market, and will go higher. When will it reach much higher levels? When will the official price be increased? Well, it may (due to controlled economies & pressed politicos) come about in at least 2 ways: the $ and the US economy can be depressed or deflated down to meet the rising free gold price, or the price of gold can rise to meet a still inflating $ and economy."

From Indicator Digest, May 21, 1968: "Last week, apparently the Europeans were losing patience over our inability to meet their demands. Time was marching on— precious time— Congress had postponed all fiscal discussions until next month, the Paris peace negotiations were starting out like nothing more than a propaganda show for the North Vietnamese, inflation was still accelerating, and the B.O.P. first quarter deficit, announced as 'improved' to $600 million (or an annual rate of $2.4 billion) was so only by virtue of special factors which masked the true deficit. These factors, as pointed out by the Dow Jones News Service last week, included $310 million worth of 'Roosa Bonds' placed by the Treasury in Central Europe during the first quarter of 1968, and other 'special transactions' which are counted in the B.O.P. as assets, but which are actually liabilities because they must finally be redeemed. Swiss bankers in particular can not be fooled by bookkeeping gimmickry, and know that our B.O.P. deficit is still running at more than a $4 billion annual rate if properly accounted."

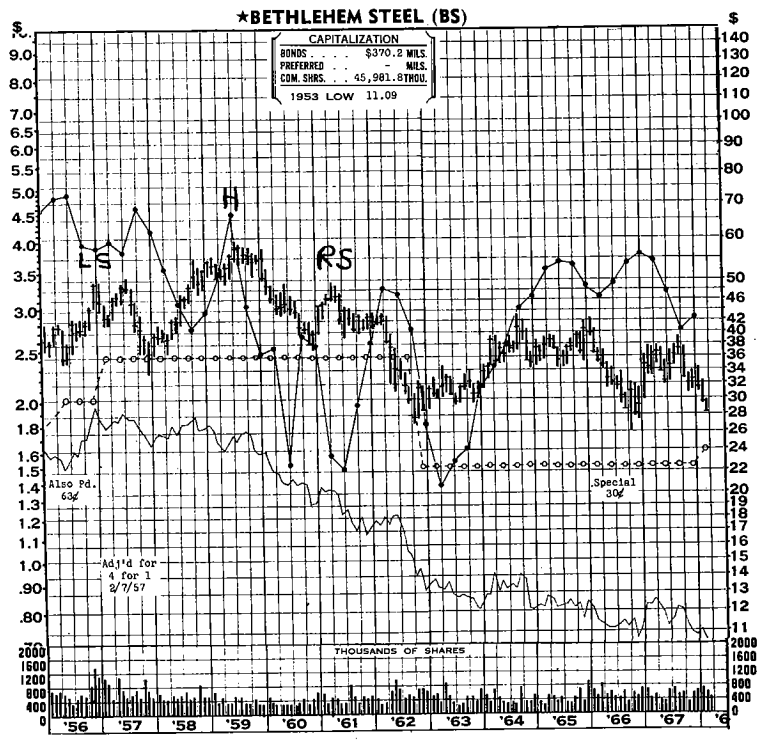
DOW THEORY MARKET LABORATORY PAGE

On the same day (May 27) that the speculative AMEX rose while hitting the third highest volume in its history, another interesting story was being told. This long-term chart (courtesy of Security Research, 208 Newbury St., Boston, Mass.) shows that the most widely distributed equity in the world, American Telephone, broke down in an important way.

Note that a seven-year "head-and-shoulder top" pattern has formed in Telephone with the classic left-shoulder, head, and right shoulder marked on the chart. I am aware that most head-and-shoulder top patterns form within a period of 3 to 6 months, and that any pattern which has consumed as much time as the Telephone pattern is open to doubt. Yet, I believe this huge top effect with the break last year to the 1960 low is a valid completion of the top for Telephone. It should be remembered that the new eight year low on Telephone means a loss of hundreds of millions of dollars for countless numbers of investors.


★AMERICAN TEL. & TEL. CO. (T)
CAPITALIZATION
BONDS . . . $11,677.0 MILS.
PREFERRED . . . $726.2 MILS.
COM. SHRS. . 541,188.0 THOU.
1953 LOW 25.35
Rights Issued ex 8/13/64 Av. Val. $1.19
LS
H
RS
Rights Issued 1/21/58 Avg.Val. 48¢
Adj'd for 3 for 1 6/1/59
Rights Issued 9/11/56
Consolidated Engs.
Rights Issued 2/17/61 Avg.Val. 75¢
Adj'd for 2 for 1 6/23/64
MILLIONS OF SHARES
'56 '57 '58 '59 '60 '61 '62 '63 '64 '65 '66 '67

As a point of interest, the only pattern on the Board comparable in size to the Telephone chart is the 1957-62 head-and-shoulder top in Bethlehem Steel (see chart, courtesy of Security Research). Here we see a 7-year top, which broke wide in 1962. So powerful was the Beth Steel top that the strong 1965-66 market succeeded only in taking Beth Steel back into "supply" again in the 38-42 area, following which the stock sagged back below 30 (where it is now).



My guess is that Telephone is going to be in the doldrums or lower for many years to come. Those holding Telephone may dream about this great issue recovering to the old 60-75 area again, but my guess is that it is going to be a long and frustrating wait. The bear has got its claws into Telephone, one of the early blue-chip casualties of the bear market— and one of the most important ones.